

1 **REBUTTAL TESTIMONY (SECOND) OF**
2
3 **KEVIN MARSH**
4
5 **ON BEHALF OF**
6
7 **SOUTH CAROLINA ELECTRIC & GAS COMPANY**
8
9 **DOCKET NO. 2004-178-E**

10
11
12 **Q. ARE YOU THE SAME KEVIN MARSH WHO HAS PREVIOUSLY**
13 **TESTIFIED IN THIS MATTER?**

14 **A. I am.**

15 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

16 **A.**The purpose of this second part my rebuttal testimony is to discuss two
17 matters related to fundamental principles of regulatory accounting as they
18 apply to the Company. First, I explain why it would be inappropriate for the
19 Commission to include short-term debt in computing SCE&G's capital
20 structure, as the Consumer Advocate's Mr. Watkins suggests in his reply
21 testimony. Second, I explain why the Company's proposed levelization of
22 turbine maintenance is the most appropriate rate making approach to these
23 expenses.

24 **Q. WHAT POSITION DOES MR. WATKINS' TAKE IN HIS REPLY**
25 **TESTIMONY?**

26 **A.**In his reply testimony, Mr. Watkins recognizes that the Commission
27 has a long-standing policy of not including short-term debt in the Company's

1 capital structure for computing the Company's cost of capital. Furthermore,
2 he recognizes that this issue was raised in SCE&G's last electric rate
3 proceeding, and that the Commission affirmatively determined not to change
4 its position on this matter. However, Mr. Watkins argues that to continue
5 applying this regulatory policy would be to provide a "windfall to
6 shareholders." (Watkins' Pre-Filed Testimony at p. 8).

7 **Q. WHY IS IT NOT APPROPRIATE TO INCLUDE SHORT-TERM**
8 **DEBT IN THE SCE&G'S CAPITAL STRUCTURE?**

9 **A.** There are several reasons why it is not appropriate to include short-
10 term debt in SCE&G's capital structure. The most important of these relates
11 to how that short-term debt is used to finance on-going capital projects, and
12 how it figures in the calculation of Allowance for Funds Used During
13 Construction, or AFUDC, as applied to on-going capital projects.

14 **Q. PLEASE EXPLAIN.**

15 **A.** SCE&G has construction work on-going at all times. This
16 construction work includes investment in major projects, like the Jasper Plant
17 and the Saluda Dam Remediation Project, and it also includes numerous
18 smaller projects, including ordinary line extensions, transmission upgrades,
19 capital projects at its generation facilities and the like. Apart from and in
20 addition to major projects, SCE&G generally maintains a balance of on-going
21 construction work in progress. The Commission typically includes in rate

1 base the balance of construction work in progress, or CWIP, on the books at
2 the end of each test year. However, since construction is an ongoing activity,
3 there is always a significant balance of CWIP that is not included in rates or
4 rate base. Attached to my testimony is Exhibit __, (KBM-1), which shows
5 that over the past five and a half years SCE&G's average balance of CWIP
6 not included in rates was \$381 million.

7 Mr. Watkins makes the assumption that short term debt is "generally
8 used to fund fuel and other supply inventories, as well as to provide cash
9 working capital" (Watkins' Pre-Filed Reply Testimony at p. 9, line 24-
10 25). This is not accurate. SCE&G uses short-term debt principally as a
11 means to finance on-going capital projects. In fact, one of the fundamental
12 assumptions that underlie the regulatory accounting rules is that short-term
13 debt is used primarily and principally to finance construction work in
14 progress that is not yet in rate base.

15 **Q. PLEASE EXPLAIN THOSE ACCOUNTING RULES.**

16 **A.** The Public Service Commission of South Carolina has adopted the
17 Uniform System of Accounts for Public Utilities. Under the Uniform System
18 of Accounts, utilities are required to compute AFUDC by a formula,
19 established under Federal Power Commission Orders No. 561 and 561-A.
20 (The Federal Power Commission was the predecessor agency to the Federal
21 Energy Regulatory Commission or "FERC.") That formula first ascribes all

1 short-term debt to the balance of construction work in progress. Only after all
2 short-term debt has been exhausted can long-term financing be used in
3 computing the AFUDC rate. In other words, following the required method
4 for computing AFUDC under the Uniform System of Accounts, all short-term
5 debt is applied in support of on-going construction, which is not yet in rate
6 base. As a result, once AFUDC is computed, there is not any short-term debt
7 available to support rate base investment and to create the 'windfall' about
8 which Mr. Watkins testified. This is an important reason why short-term debt
9 should not be included in the Company's capital structure for computing rate
10 of return.

11 **Q. WHAT IS THE REGULATORY SUPPORT FOR THIS POSITION?**

12 **A.** As FERC has stated: "Our practice of excluding short-term debt from
13 the capital structure 'is based on the premise that short-term financing does
14 not support rate base but is generally used for temporary financing of
15 construction activities.'" In re Central Telephone and Utilities Corp., 18
16 FERC ¶61,132, p.61,116 (1982). As the FERC Chief Accountant has stated
17 in a letter ruling: "In these orders [Order No. 561 and 561a concerning
18 AFUDC], the Commission adopted the premise that all short-term debt
19 should be allocated to finance short-term work in progress, in order to
20 calculate a maximum AFUDC rate, even though it is recognized that short
21 term funds can be used for many corporate purposes other than construction."

1 In re Minnesota Power & Light Co., Docket AC93-204-000 (Letter Ruling,
2 March 9, 2004).

3 As shown in my exhibit, SCE&G's on-going level of construction
4 work in progress has exceeded the level of its short term debt by an average
5 of \$228 million over the past five and a half years. Accordingly, all such
6 short-term debt is properly attributed to construction work in progress. None
7 is appropriately allocated to the Company's long-term capital structure as Mr.
8 Watkins suggests.

9 **Q. AS CHIEF FINANCIAL OFFICER, HOW DO YOU DETERMINE**
10 **THE LEVEL OF SHORT-TERM DEBT THE COMPANY REQUIRES?**

11 **A.** Our need for short-term debt is based principally on our monthly
12 construction requirements for cash.

13 **Q. HOW THEN DO YOU CONVERT SHORT-TERM FINANCING TO**
14 **LONG-TERM?**

15 **A.** We review the balance of short-term debt on a regular basis. The
16 Company converts short-term financing to long-term financing as required to
17 maintain a proper balance of short-term debt and to ensure that the Company
18 maintains a proper overall capital structure. As necessary, we add additional
19 long-term debt or equity to support the additional long-term capital we have
20 invested in our system and to maintain the appropriate capital structure for the
21 Company. The addition of this long-term financing occurs apart from the

1 issuance of short-term debt, which as mentioned above, is used to support
2 cash needs for construction while construction is taking place.

3 **Q. HOW DOES AFUDC AFFECT CUSTOMERS?**

4 **A** AFUDC reflects the cost of funds during the time when construction is
5 ongoing. AFUDC is booked to the open construction work orders and
6 becomes part of the final construction cost, akin to the way interest under a
7 residential construction loan is typically rolled into permanent financing after
8 the house is completed. When construction is included in rate base, AFUDC
9 ceases to be booked.

10 **Q: HOW DO YOU RESPOND TO MR. WATKINS' CRITIQUE OF THE**
11 **TURBINE MAINTENANCE ANNUALIZATION?**

12 **A.** Mr. Watkins challenges our turbine and generator maintenance
13 annualization on several grounds.

14 "Capital Investment" --Mr. Watkins challenges the Company's proposal
15 on the grounds that these maintenance costs are "capital investments," and that
16 the proposal results in a "double collection of investment cost." (Watkins Reply
17 at pp. 50, 51).

18 Mr. Watkins' classification of the turbine and generator maintenance
19 expenses as capital costs or capital investments is not correct. Under the FERC
20 Uniform System of Accounts, as adopted by this Commission for use by
21 electric utilities, refurbishment costs can be capitalized only if the asset is

1 returned to “like new” condition. Costs incurred to maintain the operation of
2 equipment must be classified as maintenance expense, which is not a capital
3 expenditure. The maintenance costs at issue here are part of the ongoing
4 Operating and Maintenance (“O&M”) expense of the Company, and turbine
5 maintenance costs have always been treated as an O&M expense by this
6 Commission. They cannot be reflected in depreciation expense –as Mr.
7 Watkins suggests-- nor can they be added to rate base –as Mr. Watkins seems to
8 suggest-- nor can the Company earn any return on them as it would on a capital
9 investment.

10 Known and Measurable --Mr. Watkins also argues that these costs are
11 not known and measurable. The fact that these costs will be incurred is fully
12 known. The maintenance in question is an engineering requirement. The
13 manufacturers of SCE&G’s turbines and generators have specified very detailed
14 and prescriptive schedules of required maintenance. The fact that this
15 maintenance will be required is an engineering certainty and it is fully known.

16 The costs are also reasonably measurable. In the case of existing steam
17 plants, these costs are measurable based on SCE&G’s long history of
18 experience in maintaining these units. Concerning the turbines and generators
19 at the new Jasper and Urquhart units, costs are measurable based on the
20 manufacturer’s maintenance specifications which in turn are based on the

1 manufacturer's understanding of the design and engineering requirement of the
2 units.

3 In fact, as to the five units at Urquhart and Jasper, the manufacturer
4 offered the Company a fixed-price contract for this maintenance. The Company
5 concluded that it was more economical for the Company to take a more active
6 role in this maintenance rather than leaving all of this work in the hands of the
7 manufacturer. It rejected the manufacturer's "turn-key" approach in favor of an
8 approach where the Company would itself perform or subcontract for important
9 parts of the work, and rely on the manufacturer only for those things that
10 required the manufacturer's special expertise. The Company consulted
11 extensively with the manufacturer and jointly prepared a work and cost
12 schedule based on this more economical approach. The pro forma adjustment
13 for turbine maintenance is based on this more economical approach and pricing.

14 Had the Company entered the turn-key contract, it would have cured Mr.
15 Watkins' objections and would have created an indisputably known and
16 measurable cost based on a binding, long-term contract. However, this turn-key
17 approach would have cost customers substantially more money over the long
18 term. The Company suggests that it would not be good regulatory policy to
19 discourage cost saving decisions such as SCE&G made here. Mr. Watkins'
20 proposal discourages such decisions by creating regulatory uncertainty around
21 all but the higher cost, turn-key approach.

1 Used and Useful --Mr. Watkins further states that these turbine
2 maintenance costs have not been shown to be “used and useful.” “Used and
3 useful” is not a concept that is ordinarily applied to maintenance expenses. But
4 terminology aside, these maintenance expenses are expenses related to the
5 generation of electricity by SCE&G’s plants, which are in service and providing
6 energy to customers today. The plants in question are fully used and useful and
7 the maintenance costs in question are a consequence of that use.

8 Benefits of the Proposed Accrual --The reasons that SCE&G has
9 proposed the turbine maintenance accrual are two-fold. One reason is to
10 levelize these expenses over time. As the information provided in the pro forma
11 work papers reflects, these expenses vary widely from year to year.
12 Levelization ensures that the amount recognized does not depend on the
13 accident of whether the most recent test year was a high or low expense year in
14 the maintenance cycle.

15 Establishing the accrual now is important to associate the maintenance
16 expense properly with the electric service that gives rise to it. The maintenance
17 expense that the Company will experience over the coming years is part of the
18 cost of providing electric service to customers during the period when rates will
19 be in effect. If the proper level of expense is not reflected in rates at this time,
20 then present customers will not pay the full cost of the service they receive.
21 This mismatching is something the Company seeks to avoid.

1 Protections for Customers –The Company intends to fully protect
2 customers from any possible variation in actual expenses as compared to the
3 levelized recovery. The Company proposes to accumulate any over or under
4 collections, and to report these amounts to the Commission. Under the
5 stipulation with Staff, the Company will accrue interest at the Company's
6 overall rate of return granted in this proceeding on any over collection.
7 Customers are fully protected under this approach.

8 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

9 **A. Yes.**

EXHIBIT NO. _ (KBM-1)

**South Carolina Electric & Gas Company
Schedule of Short-Term Debt Balances
and
Construction Work in Progress Balances Outstanding
January 1999 - June 2004**

Short-Term (S-T) Debt Balances Outstanding:

	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
January	\$201,500,000	\$259,904,000	\$293,394,000	\$236,690,000	\$121,871,000	\$294,275,000
February	208,100,000	224,709,000	151,942,000	88,756,000	153,806,000	175,444,000
March	77,500,000	186,698,000	93,454,000	97,864,000	114,051,000	191,065,000
April	122,700,000	179,617,000	109,968,000	161,133,000	195,884,000	224,356,000
May	103,900,000	150,681,000	117,307,000	161,498,000	61,831,000	168,476,000
June	94,700,000	136,123,000	116,463,000	212,931,000	213,357,000	167,960,000
July	135,000,000	138,969,000	130,270,000	244,341,000	199,586,000	
August	102,300,000	103,161,000	106,173,000	257,526,000	177,402,000	
September	79,500,000	105,430,000	74,774,000	248,620,000	196,220,000	
October	74,032,000	113,391,000	85,828,000	205,599,000	175,371,000	
November	54,100,000	118,661,000	83,030,000	115,615,000	66,632,000	
December	143,100,000	187,717,000	164,845,000	177,702,000	140,131,000	
Average Balance	\$116,369,333	\$158,755,083	\$127,287,333	\$184,022,917	\$151,345,167	\$203,596,000

Construction Work in Progress (CWIP) Balances Outstanding (*not included in rates*):

	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
January	\$218,898,000	\$157,048,000	\$244,300,000	\$534,211,000	\$661,357,000	\$567,497,000
February	242,327,000	170,449,000	269,256,000	556,973,000	285,037,000	582,794,000
March	262,483,000	187,983,000	295,885,000	587,574,000	300,840,000	604,345,000
April	282,130,000	192,899,000	320,601,000	605,303,000	343,859,000	622,412,000
May	293,211,000	205,052,000	344,464,000	636,459,000	385,526,000	361,974,000
June	289,379,000	214,066,000	377,107,000	424,447,000	429,194,000	338,490,000
July	295,743,000	225,144,000	407,796,000	453,230,000	454,648,000	
August	291,937,000	229,450,000	335,777,000	480,833,000	480,252,000	
September	297,493,000	244,339,000	358,880,000	514,178,000	517,464,000	
October	285,317,000	254,826,000	400,151,000	552,713,000	518,179,000	
November	276,723,000	263,518,000	446,107,000	587,008,000	475,897,000	
December	150,982,000	232,315,000	514,109,000	649,355,000	552,134,000	
Average Balance	\$265,551,917	\$214,757,417	\$359,536,083	\$548,523,667	\$450,365,583	\$512,918,667

Average Balance - Excess CWIP over S-T Debt	\$149,182,583	\$56,002,333	\$232,248,750	\$364,500,750	\$299,020,417	\$309,322,667
--	----------------------	---------------------	----------------------	----------------------	----------------------	----------------------

66 Month Average:

S-T Debt	\$152,650,515
CWIP	380,944,364
Excess CWIP over S-T Debt	<u>\$228,293,849</u>